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LAW OFFICES
PIERSON & TUTTLE
1200 NINETEENTH STREET, N.W.
SUITE 607
WASHINGTON, D.C. 20036

(202) 466-3044 / FAX: (202) 466-3055

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JUN 29 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

June 29, 1994

William F. Caton
Acting Secretary
Federal Communications Commission
Room 242
1919 M Street, NW
Washington, D.C. 20554

RE: CC Docket No. 94-1
Price Cap Performance Review for Local Exchange Carriers

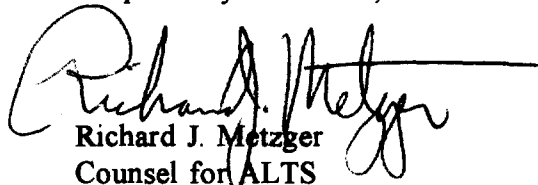
Dear Mr. Caton:

Enclosed for filing is an IBM compatible diskette, with text files in WordPerfect 5.1 and ASCII, of the Reply Comments of the Association for Local Telecommunication Services with respect to the captioned Common Carrier Bureau action. In addition, we have filed an identical diskette with the Commission's copy contractor, International Transcription Service ("ITS").

I am also enclosing a copy of this letter marked "receipt copy", with a duplicate diskette attached, to be stamped as received and returned to us.

If you have any questions concerning this filing, please contact the undersigned.

Respectfully submitted,


Richard J. Metzger
Counsel for ALTS

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In the Matter of)

Price Cap Performance Review)
for Local Exchange Carriers)

CC Docket No. 94-1

**REPLY COMMENTS OF THE ASSOCIATION FOR LOCAL
TELECOMMUNICATIONS SERVICES ON THE "TRANSITION
ISSUES" SPECIFIED IN SECTION VIII, D OF THE NPRM**

Heather Burnett Gold
President
ASSOCIATION FOR LOCAL
TELECOMMUNICATIONS SERVICES
1200 19th Street, N.W.
Suite 607
Washington, D.C. 20036

W. Theodore Pierson, Jr.
Richard J. Metzger
PIERSON & TUTTLE
1200 19th Street, N.W.
Suite 607
Washington, D.C. 20036

Its Attorneys

June 29, 1994

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SUMMARY

USTA in its initial comments in this proceeding proposes significant changes in the existing LEC price cap plan, changes which would give the LECs greatly enhanced pricing flexibility over their interstate access services. According to USTA, the safeguards built into its proposal, combined with competition from CAPs, cable TV providers, even PCS entrants, are entirely adequate to assure the Commission that the LECs could not engage in monopolistic or anticompetitive pricing.

Under USTA's proposal, each wire center would be placed in one of three categories:

- Initial Market Areas ("IMAs") -- The starting point for all wire centers. Existing price caps rules would continue to apply, but using new price baskets and service band indices proposed by USTA (downward changes would be limited to 10% a year, adjusted for price cap index ("PCI") changes).

- Transitional Market Areas ("TMAs") -- Offices where some evidence of competition exists because of: "[T]he existence of an operational expanded interconnection arrangement within the wire center. It could also be shown by the offering of a substitutable access service by a CAP, IXC, cable television operator, cellular or PCS provider, private carrier, microwave carrier or other entity within the geographic area served by the wire center." (USTA comments at 65) Downward changes would be limited to 15% a year, adjusted for PCI changes, and LECs could respond to RFPs with tailored contracts.

- Competitive Market Areas ("CMAs") -- Wire centers where "(1) at least 25 percent of the demand for the local exchange carrier's interstate access services, or 20 percent of the total market demand of interstate access services within that area, have available to them an alternative source of supply, and (2) customers ... representing at least 25 percent of the total demand within that area for

the exchange carrier's interstate access services, or a single customer whose demand represents at least 15 percent of that total, actively seek to reduce the cost of their access service through the solicitation of bids, use of private networks, or construction of their own facilities" (*id.*). No price cap regulation would apply within CMAs.

In USTA's view, the pricing flexibility conferred on these three categories of wire centers under its proposal is appropriate to the degree of competition each confronts. But USTA's proposal is fundamentally flawed in both its mechanics and assumptions:

- The criteria proposed by USTA for changing IMAs to TMAs need to be immune from LEC tampering if TMAs are supposed to reflect economic reality. However, USTA's standard for shifting a wire center from a IMA to a TMA -- a single enhanced interconnection order -- could easily be triggered through undetectable collusion between an LEC and a collaborating customer, thereby allowing LECs to game the process.

- Even if the Commission could be assured that all enhanced interconnection orders under USTA's scheme were bona fide, a single order in a wire center is not necessarily evidence of viable competition for a wire center's other access customers. End users with high-value data lines will likely order expanded interconnection at even a high price for service redundancy purposes, but this is entirely irrelevant to whether other access customers in that wire center could afford to make the same choice.

- USTA assumes that anticompetitive prices directed against existing providers of special access is the only threat it needs to accommodate in its proposal. This plainly ignores the obvious gains the LECs would enjoy if they were able to deter future investment in competitive facilities through improper pricing made possible only through USTA's proposal.

- USTA never addresses several serious analytic problems which preclude any reliance on its analysis. These include: economies of scope in the LECs' special access facilities; the distortions caused by separations; and the continued existence of incentives to predatory pricing at both the state and Federal levels.

The mechanical and conceptual faults in USTA's proposal are so serious and intractable that the Commission should reject them out of hand. Rather than searching for effective competition which does not yet exist, the Commission should sponsor negotiated attacks on the obvious barriers to competition that plainly do exist. As ALTS explained in its initial comments, the economic paradigm of "New Institutional Economics" provides a sound conceptual approach for identifying and removing those barriers through negotiated property rights, and the Commission's ENFIA experience underscores the procedural viability of such an approach.

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**REPLY COMMENTS OF THE ASSOCIATION FOR LOCAL
TELECOMMUNICATIONS SERVICES ON THE "TRANSITION
ISSUES" SPECIFIED IN SECTION VIII, D OF THE NPRM**

The Association for Local Telecommunications Services ("ALTS") hereby submits this reply to the comments of the United States Telephone Association ("USTA") concerning the transition issues set forth in paragraphs 92-100, Subsection D of Section VIII, of the Notice of Proposed Rulemaking, adopted on January 19 and released on February 16, 1994, FCC 94-10 ("NPRM").

I. USTA'S CLAIMS ABOUT COMPETITION ARE UNFOUNDED. SUBSTANTIAL BARRIERS TO EFFECTIVE COMPETITION STILL REMAIN AND CAN ONLY BE REMOVED BY THE INTERVENTION OF THE COMMISSION.

The comments of USTA and the Local Exchange Carriers ("LECs") in this proceeding are unanimous in forecasting an avalanche of competition for interstate services. LECs meticulously describe specific facilities installed in their service areas which can be used for bypass, and faithfully recite how the addition of ever-more powerful electronics could expand this competitive capacity to even higher levels. They trumpet

the advent of additional competition from cable TV providers, VSATs, PCS, cellular service, and every other new technology they see barreling down the information highway. Indeed, the crescendo of competition discovered by the LECS strongly suggests that interstate special access has become as fiercely competitive as firecracker sales on the eve of the Fourth of July.¹

But anecdotes and technohype cannot disguise the plain facts. Interstate special access remains one of the most concentrated markets in all of American infrastructure, and even the current growth rate for competitive services, assuming it remains at its current level, will not dent this monopoly until well into the next century.² None of the LECs seeking greater price cap freedom comes to grips with the fundamental fact that

¹ See, e.g., Ameritech at 30: "When all these competitive networks are overlaid together upon Ameritech's wire centers, it is clear that the bulk of Ameritech's business is subject to competition today or fairly easy competitive entry in the near future"; Bell Atlantic at 20: "The variety of alternative providers, combined with the ability to collocate at Bell Atlantic facilities, means an expansion in the level of competition going forward"; BellSouth at 11: "... [G]iven the current, rapid growth of competition in the local exchange marketplace, BellSouth believes that it is imperative for this [new price cap] framework to be adopted and implemented on an expedited basis"; Pacific Bell at 71: "In California today, as in most states, the idea of the exclusive local franchise has come to an end"; etc.

² Even assuming a 25% annual growth rate, competitive providers would not reach 50% of the local access market until 2012, ignoring market growth and other sources of potential revenue for the LECs.

competition for interstate special access is just beginning.³ As shown in the Hatfield Report, revenues from competitive access providers were less than one percent of the LECs' total access revenues in 1993.⁴

Quite understandably, the LECs choose not to dwell on the current absence of any real competition for interstate special access. Instead, they insist that meaningful competition is just around the corner, and urge the Commission to use market power definitions such as "capacity" or "addressability" because, in the words of USTA, they are "forward-looking" (USTA comments at 62).

But there is no need for the Commission at this time to try to determine the relative merits of "share," "capacity," or "addressability" as potential metrics of market power. Whatever the abstract virtues of the triggers proposed by USTA and the LECs, there will be plenty of time in the future for the Commission to choose among them, because there are no facts in this record to support a finding that special access competition has become sufficiently robust to support any substantive relaxation in LEC price cap regulation.

³ See Economics and Technology, Inc./Hatfield Associates, Inc., "The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers," (1994) ("Hatfield").

⁴ \$250 million in 1993 revenues for competitive providers compared to \$26 billion in access revenues for the LECs in 1993 (Hatfield at 31, n. 48, citing FCC Statistics of Communications Common Carriers, 1992).

The time-lines for the emergence of competition in the long distance and customer premises equipment markets amply demonstrate that special access cannot be treated as competitive now, or in the near future. It took thirteen years from Execunet II, the competitive starting place for switched long distance services, for AT&T to receive even limited streamlined regulation. It took 10 years from Carterphone in 1968 to the Commission's rejection of AT&T's protective coupling device tariffs in 1978 for CPE competition to emerge. The plain historical fact, unrebutted by USTA or any of the parties to this proceeding, is that competition in a major telecommunications market does not and cannot take place in the "flash-cut" fashion that USTA and the LECs try to portray.⁵

None of the parties to this proceeding wants a meaningfully competitive local exchange market more urgently than ALTS. However, that true competition will not come about through crossed fingers or disregard for facts. Rather, the Commission's goal of truly effective competition, as described in Part III below, will only arrive if the Commission takes an active and

⁵ Indeed, the pattern of emerging competition is not nearly so inevitable as USTA and the LECs portray. The convergence of cable and telephony that was supposed to accelerate competition in the local markets has not yet occurred. The TCI-Bell Atlantic merger has been called off, and the trial of interactive television in Orlando by Time Warner has been delayed.

While ALTS remains confident that the competitive access industry will survive, indeed thrive, the facts simply do not support the LECs' view that effective local exchange competition exists here and now.

aggressive role in policing anticompetitive behavior while assisting in the removal of the remaining structural barriers to local exchange competition.

Sponsoring the removal of these barriers would be much less burdensome than others might urge the Commission to believe. Using the "New Institutional Economics" as developed by such economists as Oliver Williamson, it is possible to identify the transaction costs which currently impede potential competitors, and then minimize those costs through the negotiation of "property rights."⁶ Nor would this task be unfamiliar from a procedural point of view. The Commission successfully sponsored the ENFIA negotiations which eventually lead to the access charge system which underlies modern interexchange competition.

The "competition" seen by USTA and the LECs is a house of cards that cannot support any further deregulation of the LECs, and reliance upon it would pointlessly embroil the Commission in legal disputes it could not win. It would be far more efficient for the Commission to sponsor negotiations that will remove the remaining barriers to local exchange competition, and thereby ultimately permit the freedom from price cap regulation sought by USTA and the LECs.

⁶ See the Duvall/Williams Monograph appended to ALTS' initial comments at 14-31. From a simple perspective, the creation of such property rights would move the local exchange market much closer to the conditions of costless entry and exit. Once costless entry and exit exist for potential competitors, the "contestability" of the market could then make continued regulation unnecessary.

II. USTA FAILS TO SHOW THAT ITS "ADDRESSABLE" WIRE CENTER APPROACH JUSTIFIES ANY ADDITIONAL LEC PRICING FLEXIBILITY.

Before discussing the substance of USTA's argument for increased freedom from price cap regulation, ALTS believes it is critical at the outset for Commission to appreciate that USTA's newly-coined term "addressability" has no connection whatever with "contestability" as that term is commonly understood and used in economic theory.

A. "Contestability" Is an Economic Theory Concerning the Relationship Between Potential Competition and Regulation, while "Addressability" is Simply a Definition USTA Applies to Wire Centers Where Competition Already Exists.

USTA adopts a unique rationale in seeking increased freedom from price cap rules.⁷ Unlike some of the RBOCs, which base their arguments for relief from price cap regulation on the theory that the local access markets are "contestable" as that term is understood in economic theory,⁸ USTA bases its argument entirely on the novel concept of "addressability" (Comments at 62):

"'Contestability' basically holds that in setting prices, the incumbent firm will be influenced by the

⁷ GTE's witness in this proceeding, Mark Schanderman, parallels USTA's witnesses Schmalensee and Taylor in his treatment of "addressability." (Schanderman at 17) Accordingly, ALTS hereby directs its reply to Schanderman as well as to Schmalensee and Taylor.

⁸See, e.g., NYNEX at 22: "Such a market has been described as contestable. See Contestable Markets and the Theory of Industry Structure, Baumol, Panzar and Willig, at pp. 349-350 (1982)"; BellSouth at 83: "BellSouth's proposal for streamlining regulation establishes criteria wherein the LEC would be required to show that specific market segments are contested"; etc.

potential for market entry by competitive providers where no barriers to competition exist.* Although it does not propose contestability as its trigger mechanism, USTA believes that the concept of contestability provides an economically sound theory for determining the degree of LEC market power.

"USTA proposes a more conservative measure of LEC market power that focuses on the proportion of access demand in a market area that is 'addressable' by alternative providers. For a customer's demand to be addressable, an alternative provider must already have facilities that can readily extend service to the customer upon request. In effect, this indicator asks: Does the customer have real alternatives available?

"Unlike market share, addressability is a forward-looking indicator. Rather than reflecting decisions that customers have made in the past, addressability asks whether customers have choices.

"* See Baumol, J. Panzar and R. Willig, 'Contestable Markets and the Theory of Industry Structure' (1982)."

USTA tries to create the impression in the above passage that "addressability" is somehow comparable to "contestability," and a more appealing standard as well (as USTA puts it, "more conservative").⁹ This is unfounded.

Although "contestability" is not a workable concept under present local exchange market characteristics, it is at least a well-understood concept in economic literature.¹⁰ Basically, a

⁹ USTA witnesses Schmalensee and Taylor make no claim that "addressability" is somehow comparable to "contestability." Their attempted defense of USTA's proposal takes a more ordinary antitrust approach. However, as demonstrated below, Schmalensee and Taylor's analysis also fails for a number of fundamental reasons.

¹⁰ See the discussion in K.E. Train, Optimal Regulation (1991) at 303-308.

market is "contestable" if (id. at 303):

" ... entry is 'free' and exit is 'costless', with both of these terms having a particular meaning. Free entry does not mean that a new firm need not incur any cost to enter an industry. Rather, free entry means that a new firm does not have to incur any costs that are not also incurred by a firm that is already producing in the industry ... Costless exit means that any firm can leave an industry (that is, stop producing) and recoup all the costs it incurred when entering ... Under these conditions, a monopolist will be forced to produce efficiently and price so as to earn zero profit."

Contestable market theory thus predicts that regulation is unnecessary in markets where the conditions of free entry and exit exist. However, as ALTS demonstrated in its initial comments, those conditions are conspicuously absent in the local access market.¹¹

Perhaps anticipating that a straightforward application of contestable market theory to local access markets cannot succeed, USTA introduces "addressability" in the passage quoted above as an ostensible substitute (USTA Comments at 62). According to USTA, "addressability" exists where a provider "already [has] facilities that can readily extend service to the customer upon request. In effect, this indicator asks: Does the customer have real alternatives available?" (Id.)

¹¹ ALTS demonstrated in its initial comments that the local telecommunications market is the antithesis of a "contestable" marketplace. Unlike markets where "contestability" is frequently applied, such as the airline industry, local telecommunications is afflicted with long-lived assets -- switches, fiber, proprietary software, etc. -- which potential competitors could never exit costlessly under current regulation. (Initial comments at 22-26)

But contrary to the impression USTA tries to create in its comments, "addressability" is not more conservative, or more liberal, or more anything than "contestability."

"Contestability" is an economic hypothesis about the effect of potential entry, while "addressability" simply identifies situations where entry has already occurred.¹²

The long and short of this is that USTA is not entitled to make claims about the "conservative" nature of "addressability" as though this were somehow adequate to defend the increased pricing flexibility it seeks in wire centers where "addressability" exists. Instead, USTA plainly has the burden of showing that "addressability" is sufficient in itself to justify pricing flexibility. USTA fails to meet that burden.

B. USTA's Proposal for Increased Freedom from Price Cap Regulation Incorrectly Assumes that "Addressability" Is Tantamount to Effective Competition.

USTA uses its "addressability" concept as the foundation for its proposal for increased freedom from price cap regulation (at 64-65).¹³ According to USTA, all wire centers would start as

¹² In "contestable" markets, the absence of market power is the casual result of specified preconditions: free entry and exit by the potential competitors to an entrenched monopolist. USTA's "addressability" approach makes no assertion at all about whether the conditions required for a "contestable" market actually exist in the special access marketplace.

¹³ See USTA comments at x:
"In classifying wire centers as TMAs or CMAs, LEC market power would be measured based on the proportion of access demand in a market area that is 'addressable' by alternative provider, i.e., where LEC competitors have facilities that can provide service to

Initial Market Areas ("IMAs") (although the term "Non-Market Area" might seem more accurate). Once the presence of an alternative provider could be documented, or an expanded interconnection arrangement is implemented, the wire center would then become a Transitional Market Area ("TMA").¹⁴ Within such a wire center, the LEC could increase prices upward by 5% and downward by 15%, adjusted for cost changes. After 25% of an LEC's special access customers in a TMA have gained competitive alternatives, the TMA would then become a Competitive Market Area ("CMA"), and essentially no price cap rules would apply.¹⁵

The assumption by USTA and its experts that expanded interconnection is a guarantee of robust competition on a wire center basis is factually and conceptually flawed for several reasons discussed below. However, even if bona fide enhanced interconnection were an accurate indicator of market power (as

a customer upon request."

¹⁴ USTA explains that (comments at 65): "Usually, this would be shown by the existence of an operational expanded interconnection arrangement within the wire center. It could also be shown by the offering of a substitutable access service by a CAP, IXC, cable television operator, cellular or PCS provider, private carrier, microwave carrier or other entity within the geographic area served by the wire center."

¹⁵ Although USTA's proposal is firmly grounded in its "addressability" concept (as plainly demonstrated in its comments at 62-66, and in the comments of Harris at 30), the term "addressability" is never used by Schmalensee and Taylor in their attempted defense of USTA's plan. Indeed, they expressly state that: "Classification as a TMA recognizes the presence of competition in a market area but implies no presumption that competitive forces can adequately prevent exploitation of market power or anticompetitive pricing" (S&T at 26; emphasis supplied).

claimed by USTA), the proposal would still be unsound on its face.

The reason for this lethal defect is simple. Since IMAs need only a single expanded interconnection order to become TMAs under USTA's proposal, LECs would have a strong incentive to obtain a "sweetheart" order from friendly IXCs or end users in wire centers where they wish to lower prices to deter entry, or otherwise engage in improper price discrimination. The opportunity for such collusive orders, which neither the Commission nor ALTS would be able to detect given the many economic interfaces between the LECs and their potential collaborators, would give the LECs the unfettered ability to "game" the pace at which they gain pricing freedom for individual wire centers without ever meeting any legitimate economic test of competitive alternatives for special access customers.

This problem is significant. Although TMA non-contract rates would be removed from calculations of the service basket indices ("SBIs") under USTA's proposal, they would still be part of the aggregate price index ("API") basket process. LECs would thus be able to recoup their foregone revenues in TMAs through higher prices (or more modest price reductions) in their price management of IMAs.

**C. Schmalensee and Taylor's Analysis of
USTA's Proposal for Increased LEC
Pricing Flexibility Is Factually Unfounded.**

ALTS agrees with the fundamental premises urged by

Schmalensee and Taylor in their analysis of USTA's proposal:

"The USTA criteria that a LEC geographic area must meet in order to receive some degree of pricing flexibility (TMA and CMA) must ensure that the additional pricing flexibility made possible would not enable the LEC to price discriminate unduly or to price anticompetitively." (Schmalensee and Taylor (hereinafter "S&T") at 8)

"The key to a successful access reform proposal is to find some way to achieve the consumer benefits from pricing flexibility without incurring efficiency losses in markets where the LEC has the ability and incentive to charge economically inefficient prices." (S&T at 4)

Working with these premises, Schmalensee and Taylor conclude that classifying a wire center as a TMA -- and thus increasing the incumbent LEC's pricing freedom -- would not result in higher prices for customers without competitive alternatives because "the prices and quantities of services sold under contract are removed from calculations of the SBI and API (for price-cap-regulated firms) and from the applicable revenue requirement (for non-price regulated firms)." (S&T at 26)

Schmalensee and Taylor thus base their analysis on the assumption that an LEC could only benefit from USTA's proposal by the strategic pricing of non-competitive interstate special access customers.¹⁶ As demonstrated below, this limited focus

¹⁶ See also Schmalensee and Taylor at 28, where this assumption becomes express:

"Because price reductions in a TMA cannot be recouped by raising prices indiscriminately elsewhere, there is no additional cost of anticompetitive behavior that could result from classifying any wire center as a TMA. If there truly were no competitors in the wire center -- and no expanded interconnection were available to encourage CAP entry and IXC

incorrectly assumes that even bona fide expanded interconnection is a valid indicator of competitive alternatives for all special access customers in a wire center, and it disregards the clear danger that LECs could use USTA's proposal to improperly deter future investment in competitive facilities.

1. Expanded Interconnection Is Not Yet a Meaningful Source of Special Access Competition for the LECs.

Schmalensee and Taylor place great emphasis on the importance of expanded interconnection throughout their analysis of USTA's proposal.¹⁷ Indeed, USTA's definition of Transitional Market Areas ("TMAs") is triggered by a single instance of an expanded interconnection order. Unfortunately for its analysis, expanded interconnection in its current state fails to provide anywhere near a clear demonstration of the existence of

expansion -- then, at worst, the additional pricing flexibility would be superfluous. The LEC would have no competitive need to reduce prices to large business customers, and if it did so, it would be unable to recover the lost revenue from price increases in other areas or to other customers."

¹⁷ See, e.g.: "Since divestiture, LEC provision of equal access, Open Network Architecture (ONA), and expanded interconnection has altered the structure of the long distance and carrier access market, opening opportunities to compete in specialized market niches and in markets for basic telecommunications services like switching and transport;" (S&T at 5); "Because of self-supply of access facilities by interexchange carriers, the existence and success of competitive entrants in carrier access markets will not be necessary to curb market power. Once expanded interconnection is implemented, irrespective of the presence of access competitors, interexchange carriers (IXCs) can purchase those pieces of the LEC's local network for which the price is below the IXC's own forward-looking incremental cost ..." (S&T at 9).

meaningful competitive alternatives in TMAs.¹⁸

One immediate problem, hopefully short-lived, is that the United States Court of Appeals for the District of Columbia Circuit has found that the Commission cannot mandate its preferred form of expanded interconnection, physical collocation.¹⁹ ALTS is confident that the Commission can formulate collocation standards that will ultimately serve the same policy goals, but this may not happen overnight, given the Commission's own finding that physical collocation provides the best means of encouraging local exchange competition.

Even beyond the immediate task of restructuring expanded interconnection -- perhaps through standards for physical collocation rather than a mandate, or by altering the economic costs of virtual collocation -- it is manifest that expanded interconnection is not some panacea that injects instant competitive vigor into every central office once it is ordered.

First and foremost, a customer's raw decision to order expanded interconnection says nothing about the availability of

¹⁸ This discussion addresses the conceptual shortcomings of Schmalensee and Taylor's analytic reliance on expanded interconnection even if every instance of expanded interconnection could be shown to be a bona fide customer choice. As demonstrated above, however, this assumption is unwarranted given the LECs' clear ability to obtain "sweetheart" interconnection orders, and thereby game the movement of IMAs to "competitive" status as TMAs.

¹⁹ Bell Atlantic Telephone Companies v. FCC, ____ F.2d ____, (slip opinion in No. 92-1619 dated June 10, 1994).

viable competitive alternatives for other access customers in a wire center. If an end user has important data channels flowing out of a wire center, it might well order expanded interconnection at considerable cost to achieve service redundancy. However, the other access customers in that wire center might not place anywhere near the same value on redundancy, yet USTA's proposal would treat them as having alternatives even though they remain as captive to the LEC as customers in IMAs.

Second, for an IXC or end user which needs high volume interconnection at a specific central office, expanded interconnection in its current form, and perhaps even at the prices currently demanded by the LECs, may well appear useful. But there are many other potential users whose needs it clearly fails to accommodate. For example, some users need ubiquitous access, perhaps analogous to terminating Feature Group D or short-haul WATS, rather than accessibility to individual wire centers. Offering expanded interconnection at a few unrelated central offices does not provide them with any meaningful competitive alternative.

Third, some services require signalling interfaces in order to take advantage of tandem switching, or to create a platform for inter-company settlements. Though progress has been made on

this front,²⁰ it is absolutely unfounded for Schmalensee and Taylor to assume that expanded interconnection in its current form provides meaningful competitive alternatives for such services.

Finally, it is not at all clear under either a physical or a virtual collocation environment how long it will take to resolve the serious pricing issues created by the LECs in response to the Commission's expanded interconnection mandate.²¹ The clear choice of the LECs has been to stretch and break the Commission's intent in their proposed prices for physical space, security arrangements, environmental maintenance, etc. Until these disputes are fairly and authoritatively resolved, it is entirely premature to rely on expanded interconnection to create widespread competition throughout the local exchange market.

USTA's choice of criteria for its CMA category also lacks economic foundation. According to USTA, a TMA would become a CMA when "(1) a sufficiently large portion of the customer demand in the wire center has an alternative source of supply available, and (2) a sufficiently large number of customers are actively

²⁰ See Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Transport Phase II, FCC 94-118, released May 27, 1994, requiring Tier I LECs to provide certain signalling information from equal access end offices.

²¹ See Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369 (1992), modified on reconsideration, 8 FCC Rcd 127 (1992), modified on second reconsideration, 8 FCC Rcd 7341 (1993).

seeking alternative sources of supply through solicitation of bids or construction of their own facilities." (S&T at 20). Neither criterion offers assurance of real competition.

An IXC might decide to direct trunk a large customer's traffic directly to its POP via competitive facilities, which could amount to 25% of the access within a wire center. However, an IXC's decision to put 25% of a wire center's access on alternative facilities does not indicate anything about the true competitive alternatives that are available to the remaining access customers. Maybe they are all identical to the single large customer, and can make the same choice. But maybe they are all small customers who lack the volume or resources to do other than take tariffed access service. Those customers will remain captive, and the LECs will understand that full well when they impose unregulated prices upon them.

**2. LECs Could Exploit Pricing Flexibility by
Deterring Additional Competitive Investment Even
If They Could Not Drive Out Existing Investment.**

As noted above, Schmalensee and Taylor consistently analyze the USTA proposal using the implicit assumption that the Commission need only concern itself with the improper pricing of non-competitive interstate special access service. However, the threat posed by USTA's proposal plainly extends beyond the manipulation of captive interstate access customers in at least two fundamental ways.

First, the hope of destroying existing competitive

facilities is hardly the only -- or even the most significant -- motivation for the LECs to engage in the strategic pricing of interstate special access. A far more compelling reason is the deterrent effect such pricing would have on future investment in any kind of competitive facilities.²² All the assumptions by the LECs necessarily assume that competitive access providers will have to make immense capital investments in order to compete. Even if LECs might not be able to extract the revenues they would lose by strategic pricing from their non-competitive interstate special access customers, they would gain the much more valuable ability to delay or preclude those customers from future access to any competitive alternatives.

Second, while most local exchange competitors do choose to attack the interstate special access market initially, their business plans are usually predicated on also eventually selling intrastate special access, local private line, ordinary local services, etc. Consequently, the incumbent provider is not concerned solely with the special access market in utilizing any increased pricing freedom. Quite the contrary, its incentive to price strategically is dictated by the benefits it would gain from slowing or precluding competition in several significant markets, not just special access.

²² See J. Ordover and G. Saloner, "Predation, Monopolization and Antitrust," in R. Schmalensee and R. Willig, Handbook of Industrial Organization (1989).